# An Analysis of *INDOPCO, Inc. v. Commissioner*

On February 26, 1992 the Supreme Court of the United States decided what may one day prove to be the most often cited tax case, *INDOPCO, Inc. v. Commissioner*.[1] The main issue involved a dispute between INDOPCO and the Commissioner of the Internal Revenue Service ("Service") concerning the deductibility of banking and legal fees incurred with respect to a friendly takeover.[2] Due to the broad language used by Justice Blackmun, the case has the potential[3] to cause much controversy[4] and litigation in areas that most thought to be closed chapters in the story of current deductibility of trade or business expenses under section 162(a) of the Internal Revenue Code ("Code").[5]

This Comment first examines cases leading up to, and which may have been overruled by, *INDOPCO*.[6] The Comment then outlines the facts of *INDOPCO* as well as its procedural and substantive holdings. Next, the Comment discusses the separate and distinct asset test, which *INDOPCO* correctly rejected. The Comment then discusses the future benefits holding of *INDOPCO* and its possible impact outside the friendly takeover arena. After discussing the possible impact of *INDOPCO*, the Comment discusses the proper test to apply when determining whether an expenditure should be currently deducted under section 162 or capitalized under section 263. In this respect, this Comment argues that courts should base their decisions on a distortion of income theory, while giving consideration to practical concerns. Finally, the Comment ends with recommendations as to how the Service should handle deductibility of certain expenses in the future.

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[1] 112 S. Ct. 1039 (1992). INDOPCO, Inc. was formerly known as National Starch and Chemical Corp. ("National Starch").

[2] *Id.*

[3] *See* Timothy J. McCormally, *TEI Warns of IRS Agents Poised to Disallow Historically Deductible Expenditures*, 55 TAX NOTES 739, 739 (1992).

[4] Recent controversy has developed concerning the deductibility of expenses incurred in removing asbestos. *See infra* notes 64–71 and accompanying text.

[5] Some of these expenses include: advertising, employee training, repairs, and expansion costs.

All section references contained herein are to the Internal Revenue Code of 1986, title 26 of the U.S. Code, unless otherwise indicated.

[6] Some commentators argue that, due to the language used in *INDOPCO* and the facts of some of the previous cases, *INDOPCO* can possibly be distinguished. *See, e.g.*, George B. Jarvas & Todd F. Maynes, *Business Expansion and Protection in the Post* INDOPCO *World*, 55 TAX NOTES 971, 972–79 (1992).

## I. THE INTERPRETATION OF *COMMISSIONER V. LINCOLN SAVINGS & LOAN ASS'N*

According to some, prior to *Commissioner v. Lincoln Savings & Loan Ass'n*[7] the law regarding the tax treatment of an expenditure was "in a state of hopeless confusion."[8] Courts had developed two tests to determine whether a taxpayer could currently deduct an expense.[9] Some courts made the determination according to whether the expenditure "result[ed] in the taxpayer's acquisition or retention of a capital asset."[10] Other courts made the determination based on whether the expenditure resulted in "business benefit[s that would be] . . . reaped . . . beyond a single year."[11] An affirmative response to either of these tests denied current deductibility and required capitalization of the expenditure.

*Lincoln Savings* involved a dispute over the deductibility of an "additional premium" paid to the Federal Savings & Loan Insurance Corporation ("FSLIC"). The additional premium related to an increase in Lincoln Savings & Loan Association's ("Lincoln") accounts that the FSLIC insured.[12] The payment was required in order to maintain the Secondary Reserve for the FSLIC's insurance obligations.[13] Lincoln carried its interest in the Secondary Reserve as an asset on its balance sheet.[14] In denying a deduction for the payment as an ordinary business expense, the Supreme Court stated:

> [T]he presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year . . . .

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[7] 403 U.S. 345 (1971).

[8] Brief for Petitioner at 14, INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992) (No. 90-1278), *microformed on* U.S. Supreme Court Records and Briefs (Microform, Inc.), (quoting Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 785 (2d Cir. 1973)).

[9] *Id.* at 15.

[10] *Id.* (quoting Louisiana Land and Exploration Co. v. Commissioner, 7 T.C. 507, 515 (1946), *aff'd*, 161 F.2d 842 (5th Cir. 1947)).

[11] *Id.* (quoting Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 393 F.2d 494, 496 (4th Cir.), *cert. denied*, 393 U.S. 962 (1968)).

[12] Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 345 (1971). The state-chartered savings and loan was compelled to make the payment pursuant to § 404(d) of the National Housing Act. 12 U.S.C. §§ 1701–1750 (1989). The payments resembled prepayments for insurance. *Lincoln Savings*, 403 U.S. at 345.

[13] *Lincoln Savings*, 403 U.S. at 348–51.

[14] *Id.* at 351. The Court determined that Lincoln's interest in the Secondary Reserve was in fact an asset. *Id.* at 355.

> What is important and controlling, we feel, is that the [expenditure] serves to create . . . a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not . . . deductible under § 162(a) . . . .[15]

Regardless of whether the *Lincoln Savings* Court so intended, courts and commentators interpreted this language to require the creation of a separate and distinct asset in order to deny current deductibility.[16] Accordingly, in *Briarcliff Candy Corp. v. Commissioner*,[17] the Second Circuit adopted the separate and distinct asset test.[18] *Briarcliff Candy* involved a dispute over the deductibility of expenses incurred in an intense campaign to entice retailers to become franchise sellers of the taxpayer's candy.[19] The Commissioner denied deductibility of much of the expenses on the ground that the taxpayer incurred the expenditures to acquire "capital assets 'consisting of . . . valuable franchise contracts.'"[20] On appeal, however, the Second Circuit disagreed, holding that the expenditure did not create a separate and distinct asset.[21] Consequently, under the impression that *Lincoln Savings* created a separate and distinct asset test, the expenditures were currently deductible under section 162(a).[22]

The Fourth Circuit followed *Briarcliff Candy*'s interpretation of *Lincoln Savings* in *NCNB Corp. v. United States*.[23] As a result, because no separate and distinct asset was created, the Fourth Circuit permitted a current deduction for expenses incurred by a bank in developing and operating a system of branch banking facilities.[24] Because the Second and Fourth Circuits' interpretations of *Lincoln Savings* conflicted with that of the Third Circuit in the case at hand, the Supreme Court granted certiorari to resolve the issue.

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[15] *Id.* at 354.

[16] Brief for Petitioner at 11, INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992) (No. 90-1278), *microformed on* U.S. Supreme Court Records and Briefs (Microform, Inc.). "Since the Lincoln Savings decision in 1971, the court of appeals for six circuits—the second, fourth, fifth, eighth, ninth, and tenth—have followed the 'separate and distinct asset' test." *Id.*

[17] 475 F.2d 775 (2d Cir. 1973).

[18] *Id.*

[19] *Id.* at 777–78.

[20] *Id.* at 780.

[21] *Id.* at 786. The franchisees agreed only to use their best efforts to sell the candy. The franchisees did not agree not to sell other manufacturers' candy, and they did not guarantee any minimum amount of sales. *Id.*

[22] *Id.* at 786–87.

[23] 684 F.2d 285 (4th Cir. 1982).

[24] *Id.* at 289–90.

## II. *INDOPCO, INC. V. COMMISSIONER*

INDOPCO, Inc. (previously National Starch and Chemical Corp.) is a Delaware corporation that manufactures and sells adhesives, starches, and chemical products.[25] In late 1977, one of National Starch's customers, Unilever United States, Inc. ("Unilever"), expressed an interest to National Starch about the possibility of a friendly takeover.[26] Frank and Anna Greenwall were National Starch's largest shareholders. The Greenwalls owned approximately fourteen and one half percent of the corporation's six and one half million outstanding shares.[27] Concerned about their income tax planning, the Greenwalls indicated that they would cooperate with the takeover only if a tax-free transfer were possible.[28]

With the use of two newly created subsidiaries, lawyers representing both sides devised a "reverse subsidiary cash merger" that satisfied the Greenwalls' request for a tax-free exchange under section 351 of the Code.[29] Unilever owned one of the subsidiaries, National Starch and Chemical Holding Corporation ("Holding"), which in turn owned the other subsidiary, NSC Merger, Inc. ("NSC"). Pursuant to the merger agreement, Holding exchanged one share of its nonvoting preferred stock for one share of National Starch common stock. Any of National Starch common stock not tendered to Holding was converted into cash by merging NSC into National Starch.[30]

In order for National Starch's board of directors to fulfill its fiduciary duty to National Starch's shareholders, National Starch employed the investment banking firm of Morgan Stanley to render a fairness opinion concerning the takeover. Morgan Stanley charged National Starch $2,225,586 for these services.[31] Additionally, National Starch's legal counsel, Debevoise, Plimpton,

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[25] INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1041 (1992).

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.* Section 351(a) provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation." I.R.C. § 351(a) (1988).

[30] *INDOPCO*, 112 S. Ct. at 1041. National Starch's common shareholders exchanged approximately 21% of their shares for Holding preferred stock. The other 79% was exchanged for cash. *Id.* at 1041 n.2. The Court further based its holding on the assumption that the takeover resulted in a reorganization. This conclusion has been criticized by commentators. This Comment does not address the issue of whether the takeover constituted a reorganization.

[31] *Id.* at 1042. The fees were $2,200,000 for banking, $7,586 for out-of-pocket expenses, and $18,000 for legal fees. *Id.*

Lyons & Gater, charged National Starch $505,069 for its work in consummating the takeover.[32] The deductibility of these banking and legal fees under section 162(a) was the subject of controversy in *INDOPCO*.

The Tax Court held that these expenditures were capital in nature. Consequently, National Starch could not deduct the fees under section 162(a) as ordinary and necessary business expenses on its 1978 income tax return. The Tax Court based its decision primarily on a conclusion that National Starch would receive long-term benefits from its acquisition by Unilever.[33] The Tax Court specifically held that *Lincoln Savings* was inapplicable because in *Lincoln Savings* the Supreme Court did not address the issue of deductibility when the expenses *did not* create a separate and distinct asset.[34] On appeal, the Third Circuit rejected National Starch's argument that *Lincoln Savings* created a separate and distinct asset requirement for capitalization and affirmed the Tax Court's holding that the fees were nondeductible under section 162(a).[35]

The Supreme Court granted certiorari "to resolve a *perceived* conflict" regarding the application of *Lincoln Savings* in the circuit courts.[36] The Court began by stating that "an income deduction is a matter of legislative grace,"[37] and the taxpayer bears the burden of proving an entitlement to any deduction.[38] The Court further held that, because deductions are specifically enumerated and capital deductions are not exhaustively enumerated,[39] when a conflict between the two arises, deductibility must yield to capitalization.[40] The Court then stated that:

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[32] *Id.* The legal fees paid to Debevoise were originally not deducted by National Starch under § 162(a). However, after the Commissioner disallowed a current deduction for the banking fees, National Starch, upon seeking redetermination in the Tax Court, asserted the right to deduct the $505,069 in legal fees as well. *Id.*

[33] National Starch and Chemical Corp. v. Commissioner, 93 T.C. 67, 75 (1989), *aff'd*, 918 F.2d 426 (3d Cir. 1990), *aff'd sub nom.* INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992).

[34] *Id.* at 77.

[35] National Starch and Chemical Corp. v. Commissioner, 918 F.2d 426, 928-31 (3d Cir. 1990), *aff'd sub nom.*, INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992).

[36] *INDOPCO*, 112 S. Ct. at 1042 (emphasis added). Commentators have argued that perhaps some of the circuit court opinions were not overturned and can be reconciled. They point to the Court's use of the words "perceived conflict" in support of this argument. *See* McCormally, *supra* note 3.

[37] *Id.* at 1043 (citing Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943)).

[38] *Id.*

[39] *Id.*

[40] *See id.*

> *Lincoln Savings* stands for the simple proposition that a taxpayer's expenditure that "serves to create or enhance . . . a separate and distinct asset" should be capitalized under § 263. It by no means follows, however, that *only* expenditures that create or enhance separate and distinct assets are to be capitalized under § 263.[41]

The Court continued to expand its analysis of *Lincoln Savings* stating that *Lincoln Savings* did not "prohibit reliance on [a] future benefit as a means of distinguishing an ordinary business expense from a capital expenditure."[42] The Court then stated that realizing benefits beyond the year in which the taxpayer incurs an expense is "undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[43] Holding that the fees involved were related to significant future benefits, the Court denied a deduction as an ordinary and necessary business expense and required capitalization.[44]

The Court identified a number of so called "future benefits" that would be generated as a result of the takeover. One of the benefits the Court identified was that the availability of Unilever's resources would broaden the corporation's opportunities.[45] The Court also recognized the possibility of synergy between National Starch and Unilever given the nature of the two companies' operations.[46] Furthermore, in upholding the Tax Court's decision, the Court implicitly held that the takeover resulted in a long-term benefit, because otherwise, given their fiduciary duties, the board of directors would not have approved the transaction.[47]

As Richard M. Lipton indicates in an article discussing *INDOPCO* and its possible consequences, "[a]lthough the [*INDOPCO*] Court's analysis of *Lincoln Savings* rebutted the oft-cited proposition by optimistic taxpayers that the absence of a separate asset permits deductibility, the [case] did not answer the more significant question of whether capitalization *always* follows the existence

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[41] *Id.* at 1044. Justice Blackmun continued, "In short, *Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient but not a necessary condition to classification as a capital expenditure." *Id.* (citing General Bancshares Corp. v. Commissioner, 326 F.2d 712, 716 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964)).

[42] *Id.*

[43] *Id.* at 1045 (citing United States v. Mississippi Chem. Corp., 405 U.S. 298, 310 (1972) and Central Tex. Savings & Loan Ass'n v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984)).

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] *See id.*

of a long-term benefit."[48] Due to the extremely broad language used in *INDOPCO*, expenses that have historically been deductible are now in jeopardy of being attacked by the Service as capital expenditures.[49]

Indeed, by June of 1991 IRS agents had already begun citing the Third Circuit opinion (*National Starch and Chemical Corp. v. Commissioner*)[50]as authority for "disallowing deductions for expenses totally independent of any corporate restructuring or acquisition."[51] Taken to its logical extreme, any corporate expense produces a long-term benefit and therefore must be capitalized. In support of this conclusion, one must note that directors and officers owe a fiduciary duty to both the corporation and its shareholders to incur only those expenses that are in the best interest of the corporation.[52] The mere fact of future benefit, however, as this Comment attempts to explain, should not be the sole determining factor as to whether an expense is capitalized versus expensed.

## III. THE SEPARATE AND DISTINCT ASSET TEST

The determination of whether an expense is a capital expenditure or a current business expense depends on the particular facts involved and the "relation of the payment to the type of business in which the taxpayer is engaged."[53] Some industries treat certain expenses differently than other industries. One taxpayer may capitalize an expenditure that another taxpayer in a different industry expenses in the current taxable year.[54] As the Supreme Court has noted, "the 'decisive distinctions' between current expenses and capital expenditures 'are those of degree and not of kind.'"[55]

When considering the tax treatment of an expenditure based on a theory of distortion of income, it becomes apparent that the separate and distinct asset test is incorrect. The *Lincoln Savings* reference to the separate and distinct asset

[48] Richard M. Lipton et al., *Supreme Court Approves Focus on Long-Term Benefit in Takeover Expense Controversy*, 76 J. TAX'N 324, 326 (1992).

[49] McCormally, *supra* note 3, at 739.

[50] 918 F.2d 426 (3d Cir. 1990), *aff'd sub nom.*, INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992).

[51] Brief of Tax Executives Institute, Inc. as *amicus curiae* in support of Petitioner at n.10 and accompanying text, INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992) (No. 90-1278) [hereinafter *Brief of Tax Executives*].

[52] Lipton et al., *supra* note 48, at 327.

[53] MERTENS, LAW OF FEDERAL INCOME TAXATION, Callaghan, § 25.37 at 116.

[54] *Id.*

[55] INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1044 (1992) (citing Welch v. Helvering, 290 U.S. 111, 114 (1933)).

as the controlling factor, and its rejection of the future benefit as the controlling factor, led many courts to the incorrect result of current deductibility where no separate and distinct asset could be found.[56] As previously stated, *Briarcliff Candy* interpreted *Lincoln Savings* as creating a "shift in emphasis" from whether the benefit extended well into future taxable years to whether the taxpayer acquired a separate and distinct asset.[57] When the Second Circuit failed to find a separate and distinct asset from the expenses incurred in obtaining the franchise agreements, the court permitted a current deduction under section 162(a).[58]

By taking a current deduction when the taxpayer derives significant future benefits from the expenditure, the taxpayer distorts its current and future income. Current income is too low and future income is too high. This is not a true reflection of income. Where it is administratively practical, the taxpayer should match the expenditure with the income it produces. That an expenditure does not create a separate and distinct asset in no way means that the expenditure necessarily produces income in the same taxable year in which the taxpayer incurred the expense. By allowing such a deduction, the separate and distinct asset test assesses taxes according to the taxpayer's net worth after the expenditure is made.[59] Such a rule has been criticized as merely leading the Service to develop creative ways in which to label benefits derived from a

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[56] John W. Lee, *Doping Out the Capitalization Rules After* INDOPCO, 57 TAX NOTES 669, 674 (1992).

[57] *See supra* notes 16–22 and accompanying text.

[58] Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 786–87 (2d Cir. 1973).

[59] *See* Charles A. LoFaso, *An Argument for Current Deductibility of a Target's Expenses in a "Friendly Takeover,"* 38 BUFF. L. REV. 801, 807–08 (1990). LoFaso states:

> Thus while the receipt of an item is income if it represents an "accession[] to wealth" (*i.e.*, an increase in net worth), an expenditure is deductible if it currently reduces the taxpayer's net worth. A taxpayer who has exchanged an asset, say cash, for a benefit which does not extend beyond the taxable year . . . is entitled to a current deduction against taxable income. The deduction reflects the decrease in the taxpayer's net worth resulting from the exchange of an asset for a benefit consumed within, and thus allocable to, the current accounting period. In other words, an asset has been transformed into an expense of current operations.
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> Conversely, when one asset, cash, is exchanged for another asset having utility beyond the current accounting period, net worth is not affected by the expenditure.
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> . . . .
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> [If] the expenditures . . . did not enhance the value of the asset being acquired[,] [then taxation based on net worth requires current deductibility].

*Id.* at 807–11 (footnotes omitted).

taxpayer's expenses as an asset.[60] Additionally, there are many other instances in which a separate and distinct asset has arguably not been created, yet the Code requires capitalization. Some of these instances include start-up costs of a new business, certain minimum educational requirement expenses, and expenses related to finding a new job in a different occupational field.[61]

The separate and distinct asset test works fine when applied to the acquisition of tangible assets. However, when mechanically extended to all expenditures in the form of a definitive test, "the doctrine . . . produces [a] distortion of income . . . [as well as] conceptual distortions and inevitable conflicts in line-drawing" as to whether or not a separate and distinct asset has been acquired.[62]

## IV. THE "FUTURE BENEFIT" HOLDING OF *INDOPCO, INC. V. COMMISSIONER* AND ITS POSSIBLE REACH

To the extent that *INDOPCO* laid to rest the separate and distinct asset test, the case is correct and the Supreme Court should be commended. However, to the extent that it created a new test requiring capitalization whenever an expenditure produces future benefits, *INDOPCO* is misguided. In many cases such a rule will result in no clearer a reflection of income than the separate and distinct asset test. The only difference is that the distortion of income will be in the opposite direction.[63] Instead of current income being too low and future income too high, as with the distortion under the separate and distinct asset test, an automatic requirement of capitalization where a future benefit is found will cause current and future income to be overstated until the taxable year in which the benefits from the expenditure cease, and often not until the business entity itself ceases to exist.[64]

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[60] Alan Gunn, *The Requirement That a Capital Expenditure Create or Enhance an Asset*, 15 B.C. INDUS. & COM. L. REV. 443, 489 (1974). Professor Gunn argues that the different tax treatment for acquired goodwill and self-developed goodwill is justified. *Id.*

[61] Lee, *supra* note 56, at 675.

[62] *Id.* at 675–76 (footnote omitted) (citing various cases pointing out the problem).

[63] This assumes that capitalization will continue under the Code as it currently exists. In many situations there will be no way to recover the cost of the capital expenditure. The author of this Comment disagrees only with indefinite capitalization and agrees that capitalization with a "proper" recovery would be the correct treatment. However, as this Comment points out, there are some expenditures that produce future benefit but nevertheless should be currently expensed even when an amortization period can accurately be shown.

[64] This assumes that the taxpayer cannot recover the expenditure by amortization under any of the existing Code provisions.

Many fear that the Service has interpreted *INDOPCO* to mean that the test is solely a question of future benefit. For instance, *Forbes* writer Laura Saunders states that "the Supreme Court's *INDOPCO* decision has created 'chaos' . . . [and] 'has the tax world up in arms [because of] the absurdly broad language the Justices used.' The IRS victory has 'meant a license for the government to disallow all manner of normal business deductions.'"[65]

The likelihood that the IRS will apply *INDOPCO* to other business expense areas is quite apparent in the Service's recent Technical Advice Memorandum ("TAM") 92-40-004.[66] This TAM states that costs for removing asbestos insulation from manufacturing equipment and replacing it with nonharmful insulation is a nondeductible capital expenditure.[67] The IRS made this determination by stating that the expenditures increase the value of the taxpayer's equipment. The Service indicated that long-term benefits accrued as a result of the expenditure. The Service pointed to findings that the taxpayer had a lower liability risk, that the equipment was more marketable because property without asbestos is more attractive than property with asbestos, and that there were safer working conditions for employees.[68] In *Plainfield-Union Water Co. v. Commissioner*,[69] however, the Tax Court held that expenses associated with replacing tar-lined water pipes with cement-lined pipes were currently deductible under section 162(a).

In *Plainfield-Union*, the Tax Court held that "a[n] expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."[70] The Service now attempts to distinguish *Plainfield-Union* on the grounds that "the asbestos was not removed because of its ineffectiveness as an

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[65] *Forbes Writer Says* INDOPCO *Decision Has Created Chaos*, 92 TAX NOTES TODAY 239-61 (1992).

[66] A TAM is a private ruling released by the IRS explaining how the Service intends to rule on a particular matter. TAM's are not law and § 6110(j)(3) of the Code prohibits them from being cited as precedent. Tech. Adv. Mem. 92-40-004 (June 29, 1992).

[67] Tech. Adv. Mem. 92-40-004 (June 29, 1992). Interestingly, "[c]orporations that have been under increasing pressure from . . . Congress, federal regulators, and the public to step up their environmental clean-up programs say the guidance in the TAM puts them between a rock and a hard place." This ruling could possibly have a "chilling effect" on companies considering spending money on environmental concerns. It seems that this ruling has "pushed tax policy out of sync with environmental policy." Rita L. Zeidner, INDOPCO *Provides Groundwork for Denying Deduction*, 56 TAX NOTES 970, 970 (1992).

[68] Tech. Adv. Mem. 92-40-004 (June 29, 1992).

[69] 39 T.C. 333, 341 (1962).

[70] Eric R. Fox and Michael F. Solomon, *IRS Determines Asbestos Removal in Capital Expenditure*, 77 J. TAX'N 202, 202 (1992) (quoting *Plainfield-Union*, 39 T.C. at 337).

insulating material but only to meet regulatory guidelines related to health."[71] The error in this reasoning is that regardless of the purpose for which the taxpayer made the repairs, the resulting condition in the two situations is the same. Any increase in value from a situation such as the one in TAM 92-40-004 was also present in *Plainfield-Union.* After the taxpayer replaced the water pipes in *Plainfield-Union,* its property was also more marketable and valuable.

*Plainfield-Union* did not find an increase in value as a result of the expenditure, and the result should be the same when a taxpayer removes asbestos for safety reasons. However, *Plainfield-Union* did not address the question in light of *INDOPCO.* Therefore, the only plausible reason for the result in the TAM is based on the intangible future benefits mentioned as a result of the removal.[72] It is this reliance on the future benefits as the sole determining factor that has the "tax world up in arms."[73] Furthermore, reliance on future benefits will lead to as large a distortion of income as did the separate and distinct asset test.

This distortion will occur in instances such as *Briarcliff Candy* and *Lincoln Savings* because capitalization will now be required without any means by which to recover these costs in future years. The lack of a statutorily provided recovery period for this type of expenditure supports this conclusion. By not creating recovery periods, the Commissioner has argued that the "asset" or "benefit" representing the taxpayer's expenditure has an indefinite useful life and therefore cannot be amortized.[74] Courts are reluctant even to permit amortization of expenditures related to intangible benefits whose utility clearly declines over the years.[75] Although one cannot easily estimate an amortization period for future benefit expenses, indefinite capitalization of these expenditures often results in no clearer reflection of income than current deductibility. Likewise, this treatment is no more likely to reach the goal of matching expenses to the taxable period in which the expense produces income than if the expenses were currently deductible.[76] In fact, commentators argue that a current deduction in situations such as *Briarcliff Candy* would result in a clearer reflection of income.[77] For instance, as Professor Gunn has stated:

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71 *Id.*

72 *Id.* at 203.

73 *See supra* note 64 and accompanying text.

74 Gunn, *supra* note 60, at 492.

75 *Id.* at 492 & n.224 (discussing purchased customer lists and advertising campaigns where the benefit clearly declines over time).

76 *See supra* notes 62–70 and accompanying text.

77 Gunn, *supra* note 60, at 492–93.

> A deduction will at least result in the taxation of only net income, while capitalization may deny or unduly postpone any tax effect in the case of costs that should at most be deferred for a relatively short period. The effect of capitalization will give the costs tax effect only in the year when the business is sold or terminated; if the costs are rightly thought of as the costs of earning income in years close to that in which they are incurred, such a postponement would seem to distort income more than a current deduction would.[78]

## V. THE DISTORTION OF INCOME TEST & RECOMMENDATIONS FOR CERTAIN TYPES OF EXPENDITURES

Section 263(a)(1) denies a deduction for "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."[79] Courts should not read this statutory language as a technical requirement for capitalization.[80] Too much attention to the particular words used in the Code may lead one to the wrong result when determining whether an expenditure should be capitalized.[81] Rather, the critical factor in determining if an expenditure is capital in nature should be whether current deductibility causes a distortion of income.

Business expenditures should be given a tax effect that results, as closely as possible, in the least distortion of income while still considering accounting costs. Rather than having a single future benefits test determine capitalization, the Service should permit a taxpayer to evaluate the treatment of an expenditure in relation to its business and the relative amount of the expenditure to the business's overall income.[82]

In the case of some expenditures, such as nonrecurring business expansion costs, rough estimates for amortization periods should be permitted. This treatment will result in a more accurate reflection of income than no amortization at all. A more accurate reflection of income results where, despite a future benefit, the expenditure is: (1) currently deductible because the expenditure "is not substantial in relationship to the taxpayer's overall income for the year or its useful life is short,"[83] (2) currently deductible because it is a recurring expenditure in "roughly equivalent amounts,"[84] and (3) capitalized

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[78] *Id.*

[79] I.R.C. § 263(a)(1) (1988).

[80] Gunn, *supra* note 60, at 450.

[81] *See id.*

[82] That is, whether or not the expenditure is one that is recurring and in amounts that are not too disparate. This treatment also assumes that the expenditure is nondepreciable.

[83] Lee, *supra* note 55, at 680.

[84] *Id.*

and a useful life is approximated to allow for amortization when the cost is neither relatively small nor recurring in nature.

## A. *Relatively Small Expenditures*

The first case that expressly held that an expenditure was currently deductible because it resulted in a small distortion of income and most clearly reflected income was *Cincinnati, New Orleans & Texas Pacific Railway v. United States*.[85] In *Cincinnati Railway* the taxpayer operated a railroad that was governed by the Interstate Commerce Commission ("ICC").[86] Pursuant to the ICC's "General Instructions of Accounting Classifications," the taxpayer followed the "minimum rule" that required currently deducting *all* purchases of property that cost less than $500, except for land, tracks, and railroad cars.[87] Declaring that the sections of the Code are "inextricably intertwined,"[88] the U.S. Court of Claims treated the question as one of clear reflection of income "and allowed a deduction for the cost of the 'minimum rule' items."[89]

The reason for expensing items that do not have much of a distortive effect when compared to overall income is not necessarily that it results in a more accurate reflection of income.[90] Rather, the reason is that "the burden on the taxpayer of accounting for such costs through capitalization and depreciation would not justify the small increase in the accuracy of determining taxable income that would result from capitalization."[91] In these situations theoretical analysis must succumb to economical practicality.[92]

## B. *Recurring Expenditures*

Recurring expenses of roughly equivalent amounts should also be currently deductible, and until *INDOPCO* many recurring expenses were given just such tax treatment.[93] If viewed in isolation, an expenditure that confers significant benefit in years to come results in a distortion of income if currently deducted.

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[85] 424 F.2d 563 (Ct. Cl. 1970); Lee, *supra* note 56, at 679.

[86] *Cincinnati Ry.*, 424 F.2d at 565.

[87] Gunn, *supra* note 60, at 454.

[88] In this case §§ 162, 263, and 446.

[89] Gunn, *supra* note 60, at 455.

[90] *Id.* at 457.

[91] *Id.* (citing Cincinnati, N.O. & Tex. Pac. Ry. v. United States, 424 F.2d 563, 572 (Ct. Cl. 1970)).

[92] *See* Lee, *supra* note 56, at 683.

[93] *See, e.g.*, Treas. Regs. 1.162-4 (repairs) and 1.162-5 (certain educational expenses relating to employment).

However, if the taxpayer has a number of recurring expenses year after year, the overall result will be a small distortion of income and current deductibility will be cost effective.[94] Professor Gunn illustrates this point with an example of a taxpayer whose business uses ten widgets at a cost of one hundred dollars each.[95] Each widget has a useful life of five years. In this situation, the taxpayer would deduct two hundred dollars in depreciation each year.[96] This amounts to the price of two widgets, which is the average number of widgets that the taxpayer would place into service each year.[97] Deducting the costs of the widgets each year as the taxpayer places them into service will thus result in the same income figure as if they were capitalized.[98] This treatment should be given to expenses such as repairs, employee training, and advertising[99] where the expenses are "regularly recurring and . . . are not substantially greater in one year than another . . . ."[100] This treatment will result in a small distortion of income and save taxpayers the burden of accounting for these expenditures through capitalization.[101]

### C. *Business Expansion Expenditures*

Business expansion costs that are neither recurring in nature nor sufficiently small in comparison to net income (such that they should not be currently deducted) should not be capitalized indefinitely. If these expenses were capitalized under the current system, a taxpayer would not recover its costs until business operations ceased. Rather, a taxpayer should be permitted to "estimate the period benefited by the expenditure, *i.e.*, the useful life, and amortize the expenditure as a freestanding asset over that period."[102] Before being reversed by the Fourth Circuit en banc, this was the holding of a panel of the Fourth Circuit concerning the business costs in *NCNB Corp. v. United*

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[94] Gunn, *supra* note 60, at 455.

[95] The example ignores, as does the Code, the time value of money. As Professor Gunn admits, such an assumption is unrealistic in an expanding business during an inflationary period. *Id.*

[96] Professor Gunn assumes straight-line depreciation on five widgets with no salvage value. (10 x $100)/5=$200. *Id.* at 455 & n.53.

[97] *Id.* at 455. Ten widgets per year, each with a useful life of five years. 10/5=2 per year.

[98] *Id.*

[99] The Service has stated that advertising will continue to be given such treatment despite *INDOPCO.* Rev. Rul. 92-80, 1992-2 C.B. 57.

[100] Lee, *supra* note 56, at 682.

[101] *Id.*

[102] *Id.*

*States*.[103] Even if only a rough estimate can be given as to the amortization period, this treatment results in a smaller distortion of income than either current deductibility or indefinite capitalization. Due to the dollar amount of these expenses, the cost of accounting for the amortization is warranted.

## VI. CONCLUSION

The Supreme Court has acknowledged that despite an ensuing future benefit, some expenses are nevertheless currently deductible.[104] The Court was likely referring to expenses relating to advertising and employee training, among others. Undoubtedly, taxpayers incur some of these expenses with an expectation of future benefits,[105] and the Court was well aware of this when it decided *Lincoln Savings*. The statement in *Lincoln Savings* regarding deductibility of some future benefit expenses was the law then and should remain the law even after *INDOPCO*. Rather than a determination based solely on a future benefit analysis, the test should be made according to a system that results in the smallest overall distortion of income.[106] This entails currently deducting some expenditures that provide benefit beyond the current taxable year.

Furthermore, the Service should be more realistic in making its tax policies. Capitalization requirements should not be viewed without consideration of an allowance for a depreciation deduction. If the Service is going to require capitalization, then it should provide a system for taxpayers to recover the costs of the expenditures that reflects income as closely as administratively feasible. As this Comment has attempted to prove, this result should be accomplished with a system based on a theory of distortion of income, while recognizing administrative costs and incurring certain accounting costs only where the decrease in distortion warrants the effort necessary to obtain the increase in accuracy.

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[103] 651 F.2d 942, 962–63 (4th Cir. 1981), *vacated*, 684 F.2d 285 (4th Cir. 1982) (en banc). This reversal was based on the separate and distinct asset test. *Id.* For a good discussion of the case, see Lee, *supra* note 56, at 681–82.

[104] *See supra* note 15 and accompanying text.

[105] *See* LoFaso, *supra* note 59, at 818.

[106] The determination should not necessarily be based on a system that provides the most accurate reflection of income, but rather, one that provides a small distortion of income after taking accounting costs and their ensuing benefits into consideration.